RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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September 26, 1979 **LETTER 766**

Sept. 14, DJIA 879.18; PTI 1137; A-D Ratio –16.31
Sept. 21, DJIA 893.94; PTI 1144; A-D Ratio –16.52

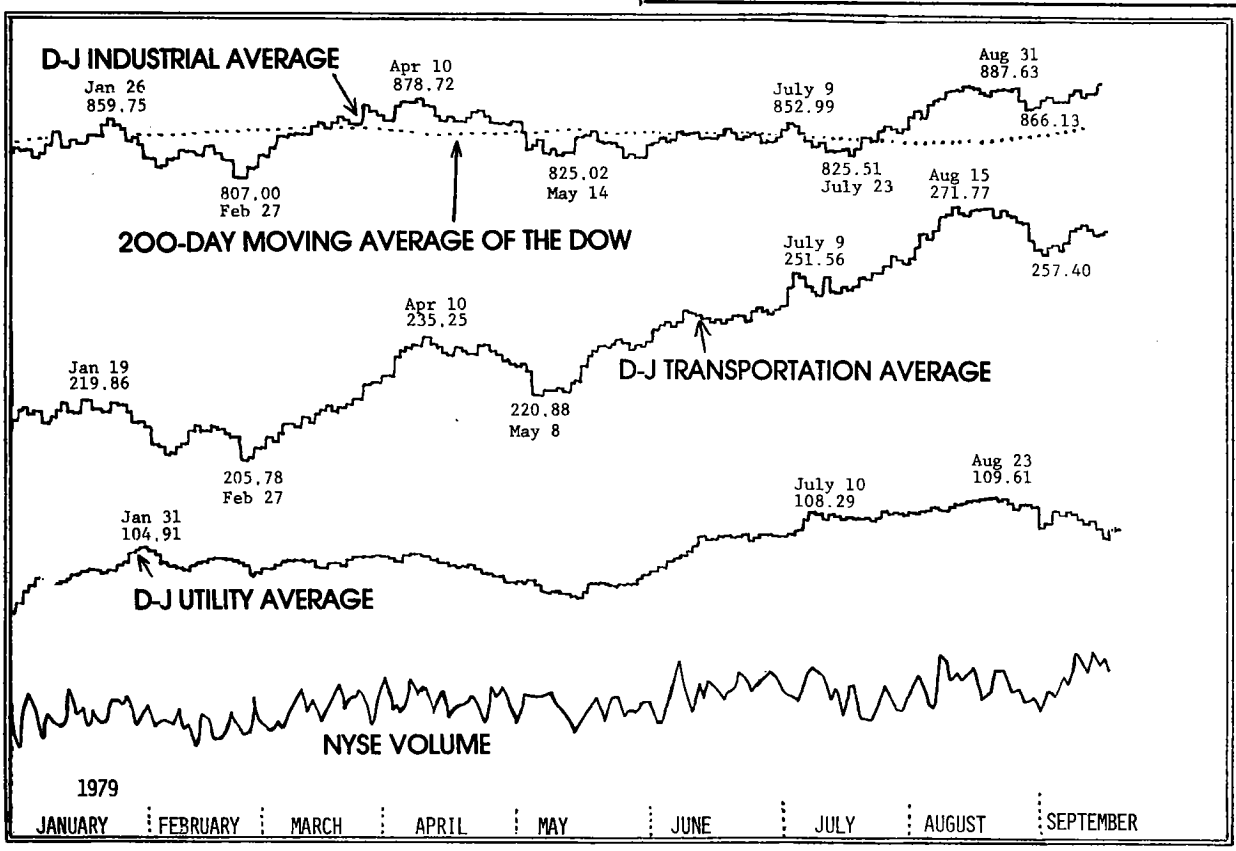
THE PICTURE: Nothing's easy, and of all the items in the world on my "non-easy list," I think I'd place the stock market first (I'm sure you have your own list). Over the past week I've done a lot of thinking about this market, and there's no doubt but that Wall Street has more critics than friends at this time. I've listed some of the things that I like about the current market.

What I like about this market is the series of rising bottoms in the Industrial Average and the great strength shown by the Transports. I like the way this market hangs on, then claws higher in the face of the never-ending, dismal news. I particularly like the way the negative volume index has turned bullish, following its July 12 low (see later section). I like the fact that the stock market, by historical standards, is selling on an outstanding VALUE basis. I like the huge (50 million) short interest on the NYSE. It seems to me that there are far too many bears around, bears who are willing to bet their cash on substantially lower prices. I like the fact that under Elliott Wave Principles, this market appears to be building a vast base, a base that should be capable of supporting a huge upward move. And of course I like the fact that on August 15, 1979, the Dow Theory signalled a primary bull market. Nothing comforts me as much as a "kindly" signal from my old friends, the Dow Jones Averages. I also like the fact that almost everyone and his brother is forecasting trouble for the markets and the economy over the foreseeable future. With so much bad news around, the bearish conclusion seems like the obvious conclusion. And I know that it pays to *beware of the obvious* in this business. At any rate,

Front Page Comment: Today we are watching one of history's great flights from paper. The flight is to gold and silver, metals that must be mined and refined through men's sweat and toil. On the other hand, the US dollar (and most paper money) is the product of a publishing venture. Politicians come up with grandiose spending programs, the money is spent, and the resulting deficits are handled via the publishing route (i.e., the money is printed).

Coming up in a month, a year, a few years (I can't time it) is the BIG PROBLEM, the problem that I've warned about for a long time. How do you get people to hold paper "money" when they have increasing doubts about its worth? The answer: you must make it CONVERTIBLE into real money–gold. Therefore, I predict again that somewhere ahead the US will be forced to make the dollar CONVERTIBLE into gold at a very HIGH, FIXED PRICE. I would guess a price of $800 to $1000 an ounce would do it. The US has been fighting gold for decades. But markets are bigger than any man, any treasury, any government. Somewhere ahead the US will halt its pitiful battle against the markets, and they will harness gold. When that happens, it will be a new ball game all around–for stocks, for bonds, for commodities.

If a man can go to the local bank and convert any or all of his paper money into gold at a moment's notice, he will hold the paper. He will hold that paper because he KNOWS that the paper is as good as gold. How does he know? He knows because his



those are some of the things I like at this juncture (there, I feel better as I list them).

Last weekend I re-read (as I often do) some of the writings of that great Dow Theorist of the 1930's, Robert Rhea. Rhea was to my mind the greatest of all "readers" of the Averages. He could read the charts the way a Cherokee reads a deer trail. When I first started in the market back in the 1940's, I spent about two years reading Rhea's works. I read them until the pages became dog-eared. I read them until I could recite Rhea passage and verse. I think for a time I was confused as to whether I was Richard Russell, Robert Rhea or Donald Duck! Rhea possessed an uncanny ability to zero in on the "innards" of the market, and I learned a tremendous amount from simply reading his work.

One of the basic tenets of the Dow Theory (and one which Rhea constantly repeated) is that the Averages represent the sum total of what everybody knows about anything that has any effect on the market. All the knowledge, the rumors, the statistics, the inside dope, the politics, the economics, the whole ball of wax, it's all built into these squiggly lines on the charts. That's what Rhea believed. That happens to be what I believe.

'Is that right," you retort. "All right, Russell, then why do you bother sending out these lengthy, rambling Letters every other week. Why don't you mail us a cold, run-down of the Averages every month or so, or whenever something's happening, and just forget all the other nonsense?"

My answer to this is not a totally convincing one–but here goes. For one thing, it would be mighty boring to write about nothing but the movements of the Averages. Had I done nothing but examine the action of the Averages since 1958 (when I started this series), I would probably be living in the "funny farm" today.

Secondly, I've always felt that in a democracy it behooves us to do more than just attempt to make money. I feel that economics and a knowledge of capitalism and the markets is part of our duty as citizens of the greatest free enterprise nation in the world. Thus, over the years, one study has taken me to the next, and I have found many of these studies to be helpful (although not necessarily just in the market).

Third, "hope springs eternal in the human breast." And egotist that I am (and I guess all so-called investment advisors must be egotists of one type or another), I keep thinking that I can increase the odds in investing by adding a study here and a study there. And since I do the work anyway I figure I might just as well publish it. Also, I like to include in these reports exactly what I am thinking and how I get there, and that's why there's more here than just pure Dow Theory.

I've said before that neither Dow's Theory nor any other theory will provide us with a consistent method for beating the market. There's no much thing as perfection in this business, and even good records are few and far between. Unfortunately, for every intelligent sentence spoken or written in this business, there's a carload of nonsense that one must wade through. But I keep trying, and the best I can do is what you read here.

Most investors fail to realize it, but Charles Dow wrote more about VALUES than anything else. Dow actually wrote ten pieces on values for every one he wrote about the price movement. Dow's successor on the Wall Street Journal, William Hamilton, wrote a good deal about the price movement and Robert Rhea carried Hamilton's forecasting methods to the point where I consider it a fine art.

government guarantees to convert each and every dollar on demand into one thousandth of an once of gold–no questions asked.

What about oil, what about the crazy energy crisis? As I see it, as I piece together the picture from a hundred sources, the Arabs have finally conceived of a plan to protect their skyrocketing mountain of dollars. What's the plan? Simple; they convert their new dollars into gold as fast as they can. The Arab's problem: how to buy all the gold available without driving the price through the roof. That's a problem the Arabs haven't solved yet, so gold has been moving higher.

I just got off the phone with one of my oldest friends and advisors, Jay Pack of Silverberg, Rosenthal in NYC. Pack's theory is that "gold is the tail and energy is the dog." He believes that the place to be is in energy companies ("the price of energy is heading higher, higher") and that the price of gold is simply a function of the price of energy. It's an interesting way of looking at the picture, and I can't argue with Pack's logic.

Nevertheless, both Hamilton and Rhea gave great stress to the principles of *values* in their Dow Theory discussions. And to my mind, this is probably an excellent spot to write a bit about values as they pertain to the current market.

One of the basic principles of values is the dividend or what a stock **returns on the investment.** Earnings can vary, methods of computing earnings can vary (from accountant to accountant), but the dividend is a solid fact. Moreover, corporations are very slow to change their dividend payouts, and once a dividend is posted or increased, corporations are extremely reluctant to lower that dividend. Thus, the dividend payout tends to be very stable and is probably one of the best methods of judging the current value of a stock.

There have only been two instances in modern history when total Dow dividends (i.e., dividends on the 30 Dow Industrials as a whole) were significantly marked down. The first time was during the worst depression in history. Dow dividends in 1929 totaled $12.75. By 1933 the total payout was reduced to $3.40, a shocking 73% cut in dividends. The second instance was 1937 to 1938. Dividends were cut in 1937 from $8.78 to 1938's $4.98, a drop of 43%.

In 1973 as the Dow and most stocks were getting ready to crash, the Dow was over 1000, it was earning $86.17 and paying out total dividends of $35.33. Thus, the Dow was providing a yield of around 3.5%. At the 1974 crash bottom the Dow dividends had actually been raised to 37.52 and the yield on the Dow at the 577 bottom was 6.5%.

Here are some comparisons. At the 1932 low (41) the Dow provided a yield of 11.2%. This was the worst crash bottom in history. At the 1942 low of 92, the Dow yielded 6.8%. At the great 1949 bottom of 161, the Dow offered a yield of 7.9%. At the 1957 low of 419, the Dow provided a yield of 5.1%. At the 1974 crash low, the Dow yielded 6.5%.

Today the estimated mid-year total of dividends for the Dow is 51.54. Based on today's Dow value, the yield for the Dow is about 5.9%. If the Dow was to slide to 800, it would yield 6.4%, almost what it did at the 1974 bottom. If the Dow was to slide to 750, it would yield 6.8% or MORE than at the 1974 bottom.

If the Dow collapsed to 700 it would yield 7.4% or the highest since 1949, when the great 17-year bull market of 1949-66 began.

The book value of the Dow (estimate mid-year 1979) is $960, and this means that the Dow is selling at about 93% of book, a rare situation. Add to this the fact that the Dow is now selling at under 7 times earnings, and you get a picture of the Dow as an outstanding value.

All right, now let's turn to the daily chart of the Averages (page 1). This market still can't "get it all together," but it's certainly been trying. On August 15 the Transports hit a high of 271.77 while the Industrials touched a high for the year at 887.63. A three week decline followed, and the Averages then started up again. On September 21 Industrials exploded over 17 points to close at 893.69, a new yearly high. This time it was the Transports that lagged.

Lagging is all right in this business, and we seldom see perfect moves wherein the Averages all move to new highs together. Thus, I feel that we should sit back and give this market time. Here's what I'd like to see in the period ahead. I'd like to see Industrials better last year's high of 907.74. If Industrials better last September's peak, I would accept that action as another solid link in the bullish chain which now seems to be building.

Obviously, I would like to see Transports move up in line with Industrials, but more specifically I would like to see the Transports better their August 15 peak, thereby confirming the latest Industrial advance.

Finally, as far as the Averages are concerned, I would like to see Utilities **hold above** their September 19 low of 105.51. And (if possible with rising interest rates), I'd like to see Utilities establish a rising trend.

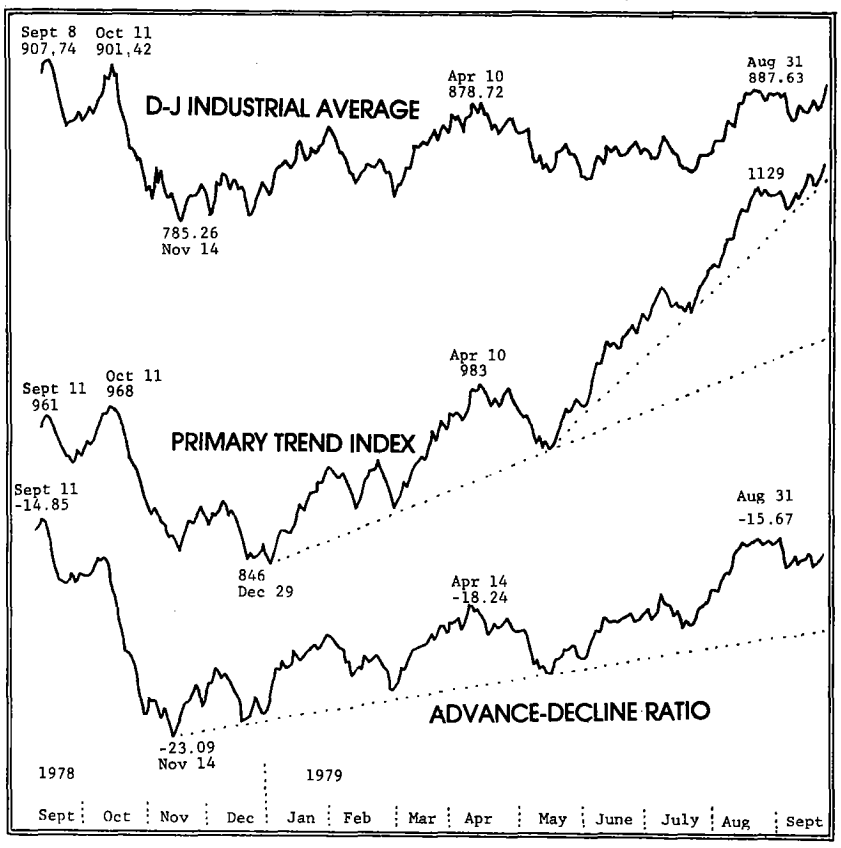
How about the downside markers? What would be the indications for trouble? Here we are lucky in having close downside points. They are the September 5 Industrial low of 866.13 and the September 6 Transports low of 257.40. A violation of BOTH of these points would turn the secondary trend down. A violation of one of these points (i.e., a violation by a single Average) wouldn't mean a thing and would probably represent a deceptive 'scare" penetration.

So much for the Averages. Now turn to the second chart, the daily chart of the Dow, the Primary Trend Index and the A-D ratio. The spectacular performance of the PTI continues unabated. Notice that (incredibly) the PTI has held above even its recent and steepest rising trendline. Taking the current rise as having started from the November-December lows, the Dow is now "in gear" with the PTI, having rallied to a new high for the year on September 21. From the bullish standpoint, it only remains for the Dow to take out that glaring upside target, the 907.74 peak of September, 1978.

The advance-decline ratio is doing all right, but it is presenting the same kind of challenge that the Industrials are. On August 31 the A-D rose to a high for the year at minus 15.67. We had a 1 point decline, and now the A-D ratio is turning a bit sluggish. To keep this rally going I would like to see the A-D advance first above its August 31 high–and then above its peak of last September, which is about 2 points above its present level at minus 14.85.

Since May of this year the A-D has shown a new upside impetus, and you can see this as it pulls away from its shallow rising trendline. Nevertheless, the A-D has never regained the ground lost during 1978's "October massacre." Thus, I would consider a rise in the A-D above the September 11, 1978 peak of minus 14.85 to be an extremely bullish occurrence.

NEGATIVE VOLUME SIGNAL: In Letter 762 I included one of my occasional pieces on negative volume. This is one of the studies I keep which shows me where "the big money" is going (and we attempt to stay with the big money).

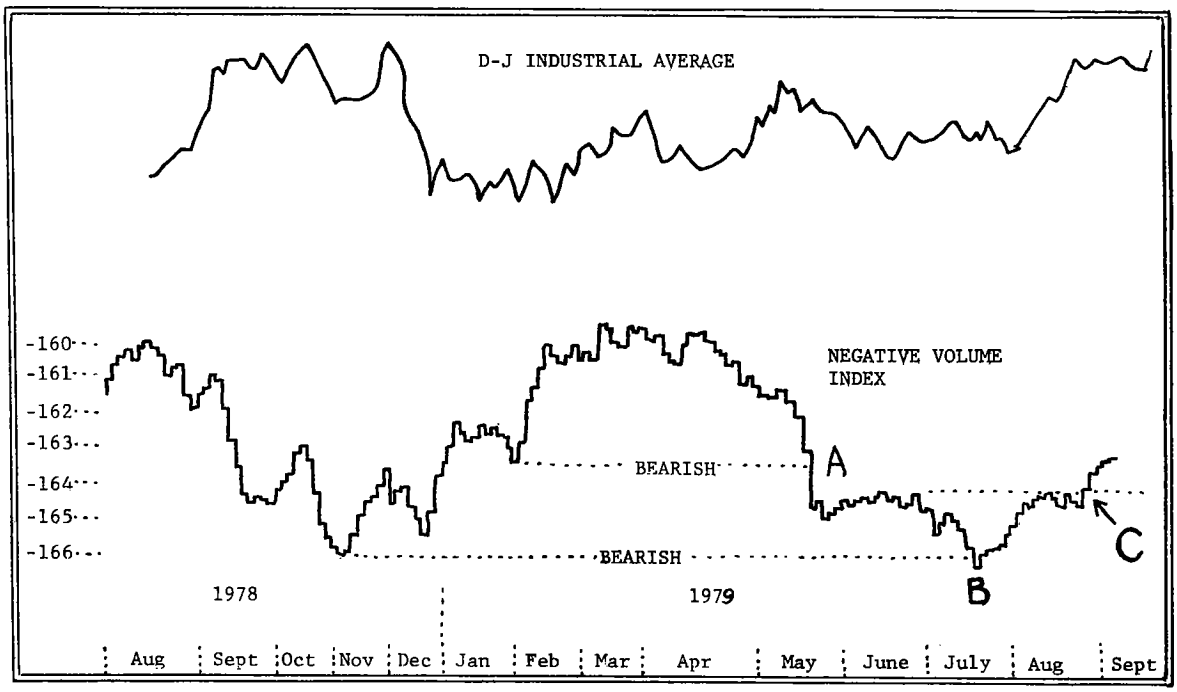


The negative volume index was developed many years ago by the late Paul Dysart. Dysart did tremendous research on market breadth, and he noted that the big money prefers to operate during QUIET markets, whereas the public is attracted (in both buying and selling) to exciting, high volume markets.

Dysart's definition of a "quiet market" was any day on the NYSE in which volume was below the preceding day. These declining-volume days he termed negative volume days.

Here's how the negative volume index works. The advance-decline differential is computed daily. If it is a negative volume day, the differential is added to a running total. If volume is up for that day, no entry appears. Theoretically, you can have five negative volume index (NVI) entries in a week, and then you would have a week with no entries at all. But it is the path of the NVI that shows us where the big big money is going. And that's what we want to know.

The last signal (Letter 762) provided by the NVI came in July (there's that month of July again). It came at point B on the chart (on page 4), and this bearish signal followed a previous bearish signal given in May (A on the chart). Significantly, the bearish signal at B was a one-day affair, and it was probably an "exhaustion drop" in that it broke below the November low–and that was it. There was NO DOWNSIDE FOLLOW-UP.



It is what followed that is so fascinating. A head-and-shoulders bottom pattern formed in the NVI (see chart), and this is one of the market phenomenons that helped to turn me bullish. Amid the steady stream of horrendous fundamental news, the NVI started to trace out a very bullish pattern. Then on August 31, 1979 this seldom-followed index pushed quietly above its June peak to rise to its highest level in four months! The head-and-shoulder bottom pattern was completed, and the inference was that big money had been (and still is) accumulating stock in the face of all the terrifying and dismal news which daily had been bombarding the stock market.

On top of this, my long-term chart of the NVI (not shown) shows a trendline which intersects the March, 1975, the January, 1976 and the March, 1979 tops. This trendline has now been reversed to the upside. I take this as an important bullish landmark for the NVI.

As a matter of interest, it should be noted that the NVI has a built-in downward bias. This is true because most market reactions and declines tend to be on lower volume. Thus, it is particularly significant when the NVI forms a recognizable bottom pattern and then pushes to higher levels.

For years the NVI has failed to produce a sustained advance. Every rise in the NVI has faltered within a few months, then turned down–and in time produced new lows. I am watching this index carefully. The NVI has already reversed a long declining trendline. If this advance is sustained we will be seeing a different kind of stock market. What kind? I believe it will be a very powerful and broadly based affair.

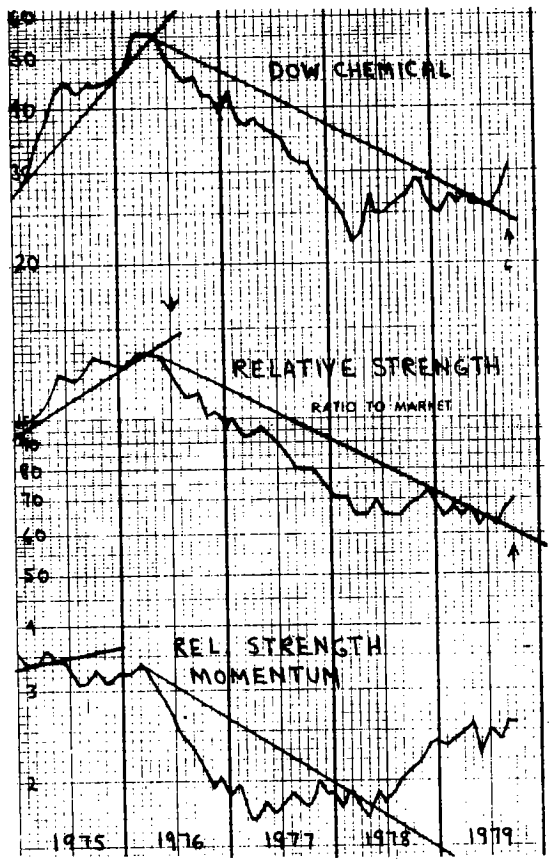
One final thought: if the NVI can continue up and better its March peak, we will have a wildly bullish structure. The NVI has a long way to go, but the March peak gives us a mark to watch.

STOCKS: I have already recommended Union Carbide in the chemical group as a buy. Last week UK hit a new high for the year. I'm adding Dow Chemical to the buy list. This chart (courtesy Ray*Signals) shows the monthly price action of Dow.

The relative strength line is now confirming price by reversing the 3 year downtrend. The momentum (6 month rate of change) of relative strength is also strongly up. Dow should be ready to outperform the market, and I like it's action.

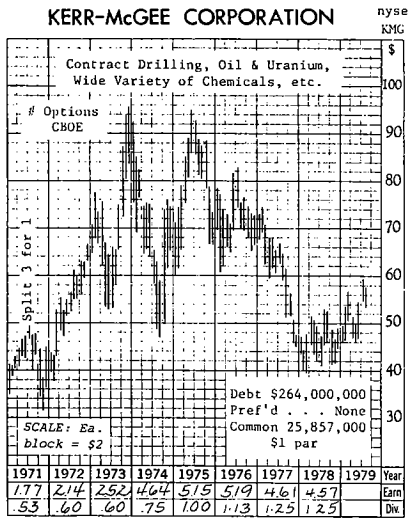
I also like Kerr-McGee, still basing in price but turning up in relative strength. This is an all-around energy stock which sold in 1973 for 95. Latest 12-month earnings for KMG are $5.85.

Kiddie & Co. (page 5) makes big money, the latest 12-mo. earnings hitting $7.01. The stock sells at around 5 times earnings, and KDE's earnings have been up every year since 1970. I show here a chart courtesy of Horsey, Salisbury, MD 21801. I see a huge base of accumulation, and bettering 40 would technically set this stock on its way to much higher levels. What can I say. I like KDE.



I think the big Dow oils are cheap. Forbes puts the appraised value of each share of Exxon at $97, each share of Standard of Cal. at $107. Exxon sells for 8 times earnings, Cal. at about the same. I like them both, even though their rising trends have been going on a while.

The following stocks in the D-J Industrial Average strike me as being particularly UNDERVALUED. (By the way, Value Line now estimates the book value of the Dow at 960). Alcoa, book value 59, 12 mo. earnings $12.67, yield 5.1%; Amer. Tel, book value 80, 12 mo. earnings 7.93, yield 8.6%; Exxon, book value 46, 12 mo. earnings 7.14, yield 7.4%; Gen. Motors, book value 62,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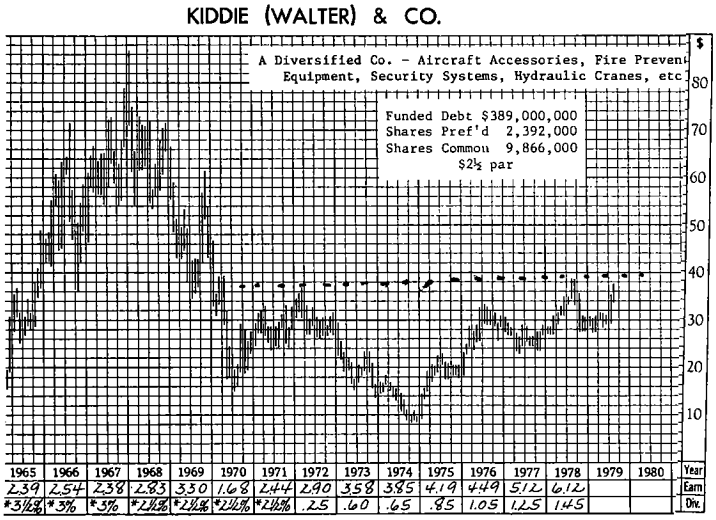
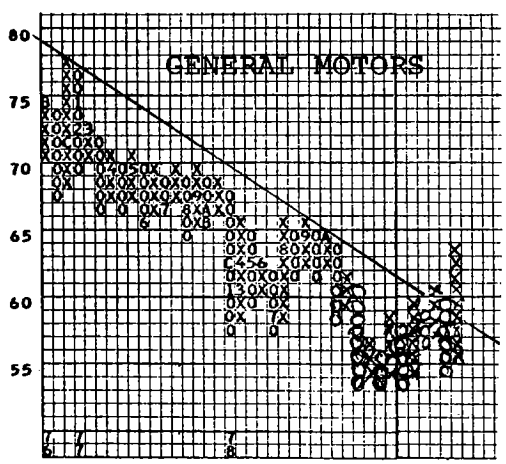
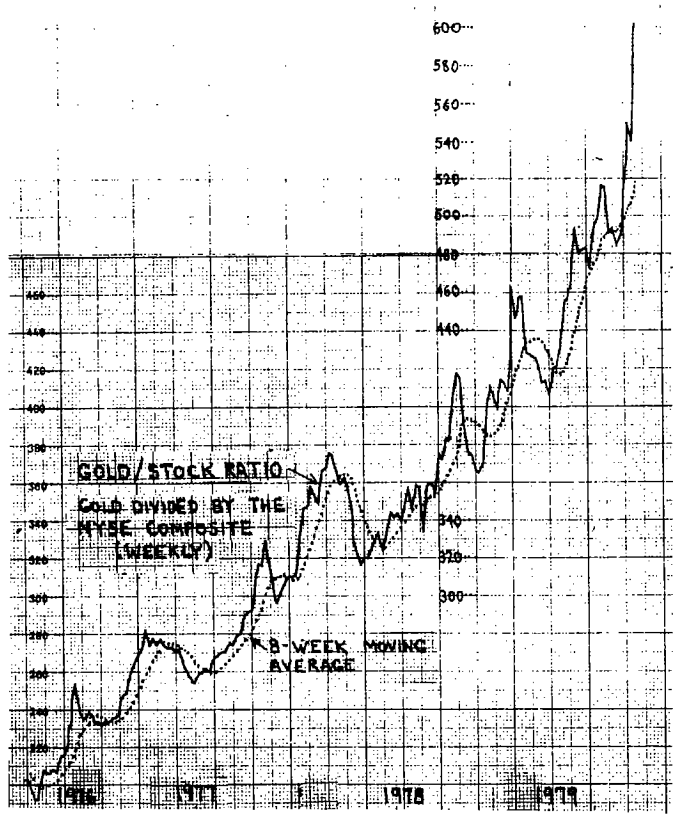


12 mo. earnings 13.87, yield 6.8%. Owens Illinois, book value 37, 12 mo. earnings 4.17, yield 5.7%. Highest Dow yielder Amer. Tel. Biggest discount from book value is US Steel, selling 62% under book. Lowest P/E is Bethlehem selling at 3 times earnings.

General Motors, long considered a market belwether, hit 64 last week. This move definitely breaks GM above a descending trendline (see chart) that has been in effect since the 1976 high. IF GM could now rally to 66, then back off, we would have a potentially very bullish head-and-shoulders bottom in this widely-watched stock.





ITEMS: My chart of the ratio of gold to the NYSE Composite is spiking upward as you can see on this weekly chart (ratio computed every Thursday). How long gold can outperform stocks is anyone's guess, but I imagine that somewhere ahead gold could slow down and stocks could speed up, at which time this ratio will correct downward. The chart shows with unmistakable clarity that investors are still prizing one thing above all—gold!

Teddy Kennedy was (up to recently) "not a candidate for President." Actually, Kennedy's brain trust had advised Teddy to wait until it was obvious that Carter couldn't win. Then Teddy could leap in as a savior, rather than a spoiler. Kennedy's new status: "An unannounced candidate with an option not to run." My own opinion: Teddy Kennedy is our next President. And he'll be a super spender.

GOLD AND SILVER: Limits up, limits down, rumors, short squeezes, shortage of metals, you name it, it's happening in the metals. Last night I heard the biggest coin dealer in the West on radio warning listeners that "this could be the top," warning them that he didn't like this kind of action! He may be right, but I don't think I ever saw a top come amid so many warnings. The San Diego Evening Tribune headlined, "Gold is Going Crazy," and if so, it's been a well-advertised madness, well advertised indeed.

There is one fact that is undeniable. The shorts have been hurt badly in this explosion and some of them have been virtually destroyed. No exchange likes to see any of its members going bankrupt, and there's been an effort to bail the shorts out, particularly in silver (bigger limits, bigger margins, pressures to sell, warnings about buying).

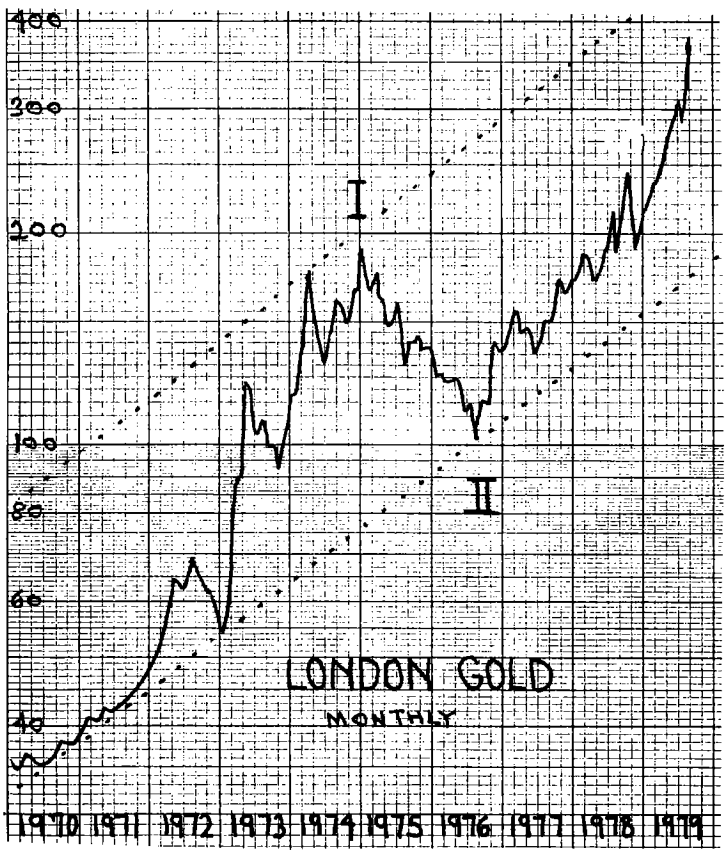
I don't know where gold (or silver) are going and nobody else does either. Even the liars are puzzled. But we know one thing, it's been a nightmare for traders. I'm including my chart (page 6) of London gold which covers the past 10 years and I have divided the movements into what I see as three major legs or waves. The first leg took gold to 193, prior to a severe correction. This leg I consider as the first psychological wave as well as the first

actual wave in the price movement. In this phase, the hard money believers bought and the public and most investors could not have been less interested.

The corrective wave (II) ended at 103 in late-August, 1976, and here anti-gold elements gloated that gold was headed for $35. The second upward wave began at the August, '76 lows and this wave is still intact. I believe that we are now in the second psychological phase of the gold bull market. This is the phase where the public steps in very gingerly, but here one does see some interest from the public. Large interests, however, still control the market during the bull market's second phase.

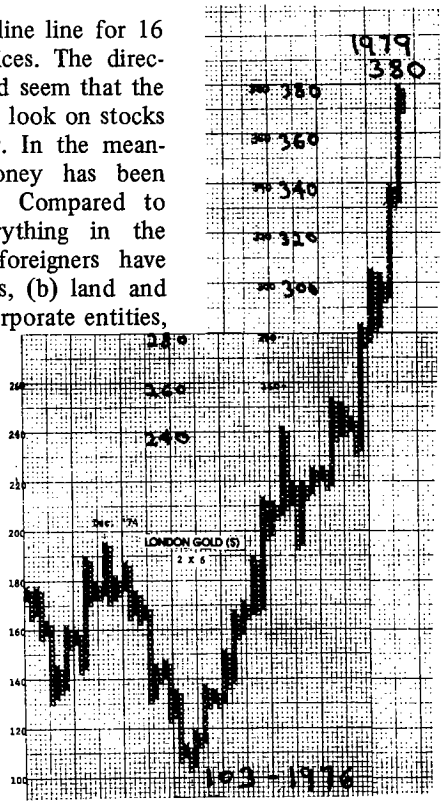
How high will this phase take gold? I have no idea, but if the second phase carries (in percentages) as far as the first, we could see gold in the mid-500's. In strong movements, the price action will often hit the upper trendline of a channel, and if this is the case with gold in this second phase, then the price could contact the upper trendline on the chart during 1979 at around 500. By the end of 1980 the upper trendline would be near 600.

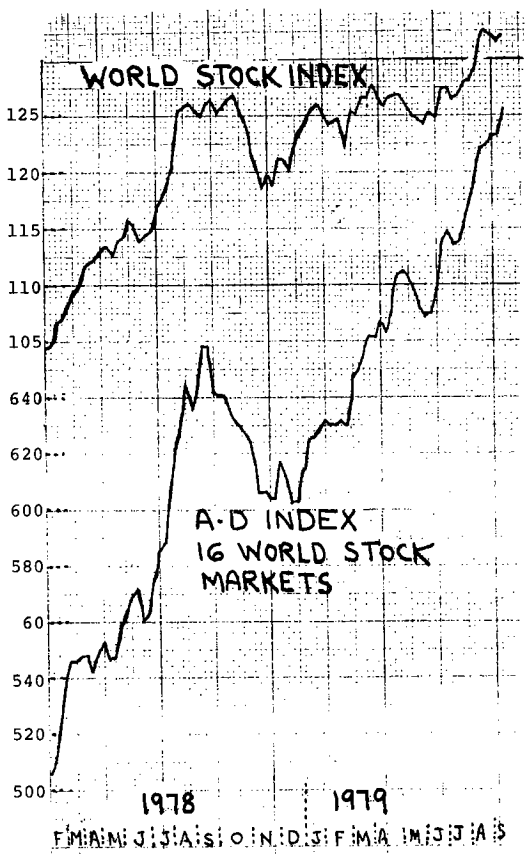
We're nowhere near the third phase of the gold bull market yet. But in case you're wondering, the third phase is the one in which the public comes in with both feet (plus wallet, bank account and the family jewels). That phase could come around 1981-83, but of course here again I'm just offering a guess.



The point & figure chart shows all gold action (each box represents 2 points) since 1974, and this is shaping up as one of the most spectacular bull charts of the past few years. What we see here is one hell of a lot of paper chasing a limited amount of gold. Furthermore, the paper is being manufactured faster than the gold can be mined. Result, "the upward spike."

LATE COMMENTS: I have a little more room on this page, and dozens of things I could say. I want to show this chart of the World Stock Index, a composite of all markets. Below it is my weekly advance-decline line for 16 international stock indices. The direction is up, and it would seem that the US is about the last to look on stocks as a haven from paper. In the meantime, international money has been pouring into the US. Compared to European prices, everything in the US is "cheap." So foreigners have been buying (a) homes, (b) land and farms, (c) entire US corporate entities,





(d) US gold auction offerings. The US, in the eyes of the Arabs, the Germans, the Japanese, the Swiss, is just one big bargain. In due time, the US stock market should move to the head of the "buy 'em" list. When that starts, the Wall Street boom will be on.

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SPECIAL ADDENDUM TO LETTER 766

The times are unprecedented. Interest rates on short term instruments are at historic highs. Gold and silver are at historic highs. Inflation is at historic highs. Investors (you and I) have nothing to protect ourselves with except our brains, our intuitions and our assets. Brains can become more accute or duller, intuition can change (or at least produce flashes of insight) and assets can change (and do) daily.

At all times, any thing I think, forecast or act on is ruled by the market. The market represents a force greater than any man or group of men. It represents a force greater than the Congress, the Treasury or all the treasuries of the world. When the market talks, I listen. If I don't listen, then I fail my subscribers, and I fail myself. To my mind, there is just no other way of looking at it–unless I want to kid myself.

In recent Letters I presented my scenario for a 5th upward wave in the stock market, a wave which would represent the finale for the great bull series that began in 1932. This 5th wave "should have started" at 821 on the Dow–during July. On that basis I suggested that subscribers move into the market to the tune of 25% to 30% of available assets.

I woke up last night (3 a.m.) feeling nervous. I traced that feeling down to the thought that I had not emphasized enough the "protective levels" which, if hit by the Averages, would indicate the possibility or potential for danger. Obviously, I would like to see the Averages hold beautifully above each of these levels, but as I've said so many times before, "They don't produce market scenerios for Richard Russell's benefit."

(1) In the accompanying Letter 766 I mentioned the recent (September) decline lows of 866.13 for the D-J Industrials and 257.40 for Transports. If BOTH of these decline lows are broken, I would lighten up on stocks–sell 1/3 to 1/2 of your position (you can always buy back).

(2) The 200-day moving average of the Dow now stands at approximately 844. If 844 is decisively broken, I would sell 1/2 to 2/3 of your total position.

(3) The lowest point for the Dow of the past few years was the 742.12 low of February, 1978. The advance from the 742.12 level carried to 907.74 in September, 1978. The HALFWAY level of that advance is 824.93. As you know (see Letter 764 on Elliott) I consider the 821 level as a landmark level. If the bull thesis is valid, 821 on the Dow must hold. Perhaps coincidentally, 821 is only 3 points below the halfway level of the 742.12 to 907.74 advance. Thus, Dow 821-824 becomes a critical area. IF the Dow breaks below 821, be totally out of the market and in 91-day Treasury bills.

Question: What if the Dow does break 821 and that move simply produces a beautiful over-sold market instead of more trouble? What have we accomplished if we sell out?

Answer: In this business, I believe in paying the price of insurance. Those who refuse to pay the insurance costs must depend on the market to be "kind" to them. In 30 years of watching the markets from both the bull and bear sides, I have seldom seen a market that I would call kind. The market has a habit of separating the fools, the naive, the hopers, the dishonest–from their money.

I'm sorry this wasn't all included in the accompanying Letter, but maybe it's better this way, since a separate addendum should serve to ***emphasize the 3 market levels discussed above.***